THE ASIAN CURRENCY CRISIS – DEBT RESTRUCTURING

The Japanese Distressed Debt Market

JEREMY PITTS

Partner
Baker & McKenzie, Tokyo

In March, 1997, the first Japanese distressed debt transaction was completed. It was a relatively small transaction involving real estate loans with a face value of approximately $25 million.[1] By the end of March, 1998, the Japanese press reported that more than $40 billion of distressed loans had been sold, and in earnings reports in relation to the financial year ended March 31, 1998, Japanese banks reported non-performing loans of more than $250 billion. Most observers seem to think that this figure understates the actual size of the bad debt problem in Japan. In any event, the growth in the size of the market has been remarkable, and seems set to continue for some years.

This paper will look at the reasons why this market has developed, the mechanics of the transactions, and the trends now that the market is reaching a more mature state.

THE DEVELOPMENT OF THE MARKET

For the Japanese Banks

The rapid growth of the distressed loan market in Japan has been driven by a combination of economic, political, tax and regulatory factors:

(a) economically, the value of Japanese real estate and other assets has fallen dramatically since the "bubble" economy of the 1980s. Japanese newspapers have reported that residential real estate prices in Tokyo have fallen by approximately 50%, and that commercial real estate prices have fallen by as much as 80%. This has had a profound effect on business, and corporate bankruptcies in Japan are now at their highest level since shortly after the second world war. The result of the collapse in asset prices is that the number of non-performing loans held by Japanese banks has increased dramatically;

• Gaikokuho Jimu Bengoshi: Jurisdiction of Primary Qualification – the State of New South Wales. Designated Jurisdictions – England, Wales and the State of Victoria.

1 All amounts in this paper are expressed in Australian dollars, and have been converted from Yen at the rate of ¥100 = A$ 0.85.

(b) politically, the Japanese government announced the "big bang" financial system reform program in late 1996 in response to domestic and international pressure to make the Japanese financial markets "free, fair and global". This change of policy has had two major effects. Firstly, it has become critical that the Japanese banks improve their own financial positions so that they can compete with the foreign banks who are moving into the Japanese market. Secondly, it has become more acceptable politically for Japanese banks to admit that they have bad debt problems and to be seen taking action to resolve those problems;

(c) the Japanese tax system has been a major impediment to the ability of Japanese banks to deal with problem loans. Japanese tax rules require a bank to pursue all possible remedies against a borrower before the bank is able to write-off a loan for tax purposes. This includes not only foreclosing on real estate loans, but also taking action to bankrupt the borrower and, if a personal guarantee is provided (which is common in Japan), the guarantor. Japanese banks have been reluctant to initiate bankruptcy proceedings against their customers, both because of the cost of such proceedings and because of the risk of bad publicity. The tax problem for the Japanese bank is solved if the bank is able to sell its loans to an arm's length purchaser. Following such a sale, the tax authorities will allow the bank to write off the difference between the face value of the loan (including accrued unpaid interest) and the purchase price the bank receives; and

(d) the regulatory environment has also changed significantly. Previously, Japanese banks were only permitted to sell loans to other banks and financial institutions. From June, 1997, Japanese banks have been permitted to sell distressed loans to special purpose companies. This provides much greater flexibility for investors. The government is considering a number of additional changes to the regulation of the distressed asset market, with the particular objective of encouraging securitisation. These changes are discussed in the section "Trends in the Distressed Asset Market" below.

The Japanese foreign exchange system was deregulated with effect from April 1, 1998. Before that date, it was necessary to obtain an approval from the Ministry of Finance before loans from a Japanese resident to a Japanese resident could be assigned to a non-resident.[2] Under the new rules, the prior approval requirement has been replaced with an after the fact reporting requirement.

At present, the accounting and disclosure standards for Japanese banks remain weaker than those for banks in other developed countries. However, the government has indicated that it intends to introduce further changes to corporate accounting and disclosure rules as part of the "big bang", with the objective of harmonising the Japanese rules with international rules. Stricter accounting and disclosure rules will force Japanese banks to take additional steps to improve their balance sheets, and will therefore lead to more dispositions of distressed assets.

For the Investors

The major attraction of the Japanese distressed asset market is the price of the loans being sold. Japanese banks have offered very significant discounts on the face value of loans – in the order of 85% to 95% of the face value of the loans. US investors, having experienced the savings and loan crisis in the United States in the early part of the decade, believe that they possess the valuation and work out skills necessary to derive a significant return on investments at this level. The transportability of these skills to Japan will be tested as the enforcement of distressed loans proceeds over the next few years.

A number of sellers have also indicated that, currently, the opportunities for investment in other developed countries such as the US and Europe are limited. Others see investment in Japanese

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2 There was an exception to this rule if the seller was an "authorised foreign exchange bank". This exception did not apply to assignments by other types of financial institutions.

distressed assets as a stepping stone towards a long term position in the Japanese financial markets.

THE MARKET

Overview

Distressed loan transactions are structured either as outright sales of debts or as loan participations. For convenience, the Japanese financial institution that disposes of its interest in distressed debts is referred to in this paper as "the seller" or "the bank" and the investor that acquires an interest is referred to as "the buyer".

The Sellers

The sellers of distressed assets are mainly Japanese banks – including city banks, trust banks and regional banks. Some insurance companies and leasing companies have recently entered the market. Most of the sellers are in a relatively strong financial position which means that they are able to provide valuable representations and warranties with respect to the loan portfolios.

There are a few exceptions. The most notable is Crown Leasing which was declared bankrupt in April, 1997. Crown Leasing has been involved in a number of well publicised distressed debt sales as the trustee in bankruptcy has attempted to realise the assets of the company for the benefit of its creditors. Since the trustee is unable to provide any substantial support for the sale, due diligence with respect to the loan portfolio was of particular importance with respect to the sale of the Crown Leasing debts.

The Buyers

The buyers are mainly US investment banks and financial institutions. European banks have also been involved in the market, but to a lesser degree. At this stage, most of the buyers appear to be purchasing assets for their own portfolios rather than for repackaging or resale. In most of the transactions, the buyers have formed syndicates to purchase the assets, with one buyer taking a lead role in arranging each transactions.

The Assets – Loans

The first transactions in the market all related to portfolios of commercial real estate transactions. Since February, 1998, the number of sales of commercial loans has increased rapidly.

The typical loans in a real estate portfolio are medium sized (around $5 to $20 million) and are secured by mortgages over commercial real estate (see the section under the subheading "The Assets – Mortgages" below). In many of the portfolios, foreclosure proceedings have been commenced against the debtors before the loans are sold. There has been some concern that the borrowers in relation to some of the smaller real estate loans may have links with Japanese organised crime. Where possible, buyers have insisted on the right to re-transfer loans to the seller if problems of this type arise.

The typical loans in commercial loan portfolios tend to be larger loans ($100 million or more). In many cases, the underlying borrower has been declared bankrupt, has commenced corporate reorganisation procedures or is insolvent. Some of these loans are secured fully or partially by mortgages over real estate or security interests in other assets. Some of the loans are unsecured.

One of the factors that has aided considerably in the development of the distressed asset market is that Japanese documentation for loans is remarkably standardised. The Japanese Bankers' Association has, for a number of years, promulgated standard form bank transaction documentation including general banking terms and conditions (*ginko torihiki yakujosho*), loan

terms and mortgages. The documentation is simple compared to Australian bank documentation, with a typical set of agreements running to a total of around 20 pages. Despite the simplicity, Japanese documentation grants the banks extremely broad rights. There are a number of Japanese court decisions which clearly establish the rights of the lender and the borrower under the standard documentation. All Japanese banks have adopted the Bankers' Association form without significant amendment, and the forms are accepted by Japanese borrowers without negotiation. The fact that the documentation is relatively straightforward and standardised considerably reduces the time and costs for due diligence with respect to the loan portfolios.

The Assets – Mortgages

A basic knowledge of the process for creating and enforcing mortgages in Japan is necessary to understand the mechanics of the distressed real estate loan market.

Most interests in real estate are registered with the Legal Affairs Bureau of the Ministry of Justice.[3] Land and buildings in Japan are registered separately. Registration constitutes notice of an interest in real estate, but does not confer an indefeasible title on the person registered.

Mortgages may be registered, and priority among competing mortgages is accorded on a "first to register" basis. A mortgage is created by agreement, usually in writing, between the lender and the borrower (or third party security provider). As mentioned above, the mortgage document is a relatively simple agreement. Unlike Australia, the mortgage document itself is not registered. Instead, certain information regarding the mortgage is registered on the title held by the Legal Affairs Bureau. The Legal Affairs Bureau has issued guidelines for the types of information that can be registered. This information includes details of the mortgagor, the mortgagee, the property and the amount secured. Significantly, the form does not contain any means to register restrictions on subsequent mortgages. For this reason, borrowers are free to establish second and subsequent mortgages over their properties.[4]

A mortgage may either secure a simple debt such as a term loan or may secure all moneys owing by the debtor up to a maximum amount. The registration forms and procedures for simple mortgages (*teitoken*) and all-moneys mortgages (*ne-teitoken*) are different. As part of the enforcement process for an all-moneys mortgage, the mortgage must be "crystallised" so that it attaches to a particular debt. Crystallisation is usually triggered by commencing enforcement procedures. Another important distinction is that the consent of the mortgagor is needed for the transfer of an all-moneys mortgage, but not for a simple mortgage (see the section under the subheading "Assignments" below).

During the late 1980s and early 1990s asset prices in Japan, including real estate, increased rapidly. Japanese banks and borrowers took advantage of this asset inflation by making additional loans and taking junior mortgages over the property. We are aware of cases where more than ten mortgages have been established by a borrower with respect to the same property. With the fall in real estate prices over the last few years, many of these junior mortgages have become worthless. However, despite the lack of any real economic interest in the property, junior mortgagees do retain limited legal rights under their mortgages, particularly with respect to the enforcement proceedings. Managing junior mortgagees can become a time consuming and expensive part of the resolution of the distressed assets for buyers.

The enforcement of mortgages raises other issues. Without the co-operation of the mortgagor, a private sale of the mortgaged property is not possible. In such a situation, the only remedy for the enforcement of a mortgage is public auction in accordance with the Civil Execution Act. The public

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3 The most significant type of real estate interest that is not registered is a short term lease. The effect of short term leases is discussed further below.

4 The mortgage agreement may contain a contractual restriction on the creation of subsequent mortgages, but this is of little practical effect if the mortgagor can register junior mortgages without the consent of the mortgagee.

auction process is time-consuming and the fair market value of the mortgaged property is not often realised. Many mortgagees simply initiate the process (by attachment of the mortgaged property) as a means of applying pressure to the mortgagor to pay the underlying debt or to conduct a voluntary sale.

The mortgagee is required to pay certain fees, registration taxes and stamp duties to the court in relation to the auction proceedings. Generally, these amounts will be refunded to the mortgagee from the first proceeds of the auction. If the buyer purchases a loan in relation to which public auction proceedings have already been commenced, the parties will need to negotiate the arrangements for the allocation of these costs when they are returned on the completion of the auction proceedings.

Japanese court procedures are notoriously slow and administratively burdensome. However, the Japanese judiciary have been focusing attention on the need to improve the procedures for public auctions. According to figures provided by a judge from the Tokyo District Court in a 1997 seminar, the average time to complete a public auction has fallen from more than one year to approximately 8 months. The rate of successful sales at auction has also improved from 46% in 1994 to 61% in 1997.

A number of the smaller real estate loans by Japanese banks have been made to borrowers with links to Japanese organised crime. The influence of crime groups is most significant in the public auction process. These groups seek to disrupt the auction process through:

- arranging disturbances by paid hooligans (*boryokudan*) such as the theft or mutilation of documents publicly displayed in connection with the auction; and

- the use of short term leases to prevent transfer of the possession of the property – if a short term lease[5] exists, the short term lease will take priority over the rights of the buyer of the property even if the short term lease is not registered. A short term lease to an undesirable tenant significantly reduces the value of the property. Unscrupulous building owners have granted short term leases to affiliates of organised crime groups as a means of discouraging the enforcement of mortgages.

Following amendments to the "Prevention of Unjust Acts by Gangsters Law" in 1997, the number of disturbances has fallen and, according to the Tokyo District Court, the there are "few problems of this kind in Tokyo". The courts have also taken an aggressive stance with respect to short term leases that they consider to be sham arrangements. However, the crime groups are also becoming more sophisticated, and it is becoming more difficult to distinguish leases established to thwart the mortgage enforcement proceedings from genuine short term leases.

One other significant difference between real estate lending practices in Japan compared to other developed countries is that it is most unusual in Japan for a lender to require a borrower to assign leases and rents to the lender as part of the security package. The reason is that landlords consider that it would indicate financial weakness on their part if they were to notify their tenants that the leases had been assigned (notification is necessary to perfect a security interest over the lease). Further, under Article 63 of the Bankruptcy Law and Article 106 of the Corporate Re-Organisation Law, a security interest over rent is only effective for the rental period when the borrower/lessor became subject to the bankruptcy or corporate re-organisation proceedings and for the next succeeding rental period.

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5 For buildings, a short term lease is a lease with a term of three years or less. For land, a short term lease is a lease with a term of six years or less.

THE REGULATORY FRAMEWORK

Banking Regulations – Loan Sales

Relaxation of the banking regulations relating to the sale of bank debt is one of the factors that has permitted the development of a market for distressed debt in Japan. The regulations were relaxed in June, 1997 to permit the use of special purpose companies. A number of regulations do remain, particularly with respect to the servicing of debts after the sale. However, many commentators on Japanese financial markets have indicated that it is likely that the remaining rules will soon be relaxed. If this occurs, it will lead to further growth in the distressed asset market.

Banks and financial institutions are regulated by the Ministry of Finance (the MOF).[6] Under the Banking Law and related statutes, the MOF is granted broad bureaucratic discretion to regulate Japanese financial markets. The MOF exercises this discretion by issuing circulars and guidelines, and by informal administrative guidance (*gyosei shido*). The usual pattern of regulation begins with the issue by the MOF of a broad written circular which contains general (and sometimes ambiguous) statements of policy. The MOF then encourages banks and financial institutions to seek specific approvals for new products or transactions.

This pattern holds true for the distressed debt market. The relevant circular is Kuragin 800 which was issued in 1992. As originally drafted, the circular only permitted banks and financial institutions to sell debts to other banks and financial institutions. The effect of this restriction was that most of the likely purchasers of distressed assets were prevented from acquiring an interest in the assets directly, and were required to invest by means of loan participation agreements. As discussed below, a loan participation may not always be an attractive method for investing in debt in Japan.

The circular was significantly amended, with effect from June 1, 1997. A translation of an extract of the relevant portion is attached. The most material change in the policy was to permit banks and financial institutions to transfer debts to a special purpose company (SPC). As far as we are aware, all distressed loan sales completed since June 1, 1997 have been structured using an SPC. The MOF has informally confirmed that the SPC can be either a Japanese company or a foreign company.

A number of regulatory restrictions do remain under the amended Kuragin 800. The most significant are as follows:

(a) *Resale:* The buyer of the loan is not permitted to resell the loans. However, there is no restriction on the buyer issuing transferable securities to fund the acquisition of the loans;

(b) *Servicing:* The seller must continue to service the loans. This issue has been a particular concern to a number of US asset management companies that wish to import their real estate skills into Japan. The issue can be managed to some extent by ensuring that the seller bank (the servicer) may only act on express instructions from the buyer. This issue has been a key negotiation point in a number of transactions. New legislation is currently being considered to liberalise the rules relating to servicing (see the section under the subheading "Servicing" below); and

(c) *Off-Balance Sheet Treatment:* The seller should not have any obligation to repurchase or guarantee the loan. This requirement is typical for off-balance sheet transactions. Notwithstanding this requirement, sellers have accepted the position that some limited representations and warranties are possible. It appears that the MOF has taken the position

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6 The Financial Supervision Agency will commence operations in mid-1998. Under the Japanese government's administrative reform program, the Financial Supervision Agency will take over many of the supervisory functions of the Ministry of Finance.

that the transaction will be regarded as a true sale for balance sheet purposes provided that the representations of the seller do not amount to a guarantee of the underlying loan.

Banking Regulations – Loan Participations

On June 1, 1995, the MOF issued a circular with respect to loan participations. A translation of the circular is attached. Unlike Kuragin 800, the focus of the participation circular is on the accounting consequences of a loan participations. In summary, the participation circular states that provided that the participant does not have recourse against the bank in the event of a default by the underlying borrower, the bank will be able to treat the participation as a sale of the underlying loan for accounting purposes and transfer the loan off its balance sheet. These accounting principles are followed by the National Tax Agency. Thus, if properly structured, the bank will be permitted to write off the participated loan for tax purposes.

Under a loan participation, the bank will remain the legal owner of the underlying loan, and the borrower will not be aware that the loan participation has occurred. For this reason, the bank which grants the participation will naturally remain the servicer of the loans. Participants in recent transactions have been actively trying to ensure a role in the servicing process by requiring the bank to act in accordance with the instructions of the participant or, at least, to obtain the approval of the participant before taking action in respect of the participated loans.

The Lawyer's Law

Somewhat surprisingly, the Japanese Lawyer's Law contains additional restrictions on third party servicing. Under the Lawyer's Law, only a qualified lawyer is permitted to conduct legal business in Japan. "Legal business" is defined in Article 72 of the Lawyer's Law to include the collection of debts on behalf of a third party. The effect of this provision is that it is not possible for the assignee of loans to appoint a third party to service the loans.

The Lawyer's Law provision is inconsistent with Kuragin 800 which requires the buyer to appoint the selling bank as the servicer of the loans. Most buyers take the position that action by the Ministry of Justice under the Lawyer's Law is extremely unlikely as the buyer's appointment of the bank as servicer is in accordance with an express circular from the MOF.

This issue is of greater concern where the buyer has the right to service the loans itself (for example, where the buyer purchases the loans from a bankrupt seller). In these cases, the appointment of a third party servicer must be structured in such a way as to ensure that the servicer simply provides advice to the buyer, and the buyer itself continues to deal with the borrower.

Money Lender's Registration

A person who carries on business as a money lender must be registered[7] as a money lender under the Money Lending Law. Money lending is defined to include:

(a) the lending of money (by discounting or otherwise); and

(b) the brokerage of money lending transactions.

An investor that wishes to make loans in Japan must be registered as a money lender. If the investor simply buys and services existing loans, the general view is that this activity will not constitute money lending since there is no advance of new funds to Japanese borrowers. The

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7 If funds are to be raised by taking deposits, the investor will be considered to be engaged in banking business for which a banking license is required.

Money Lending Law is administered by the MOF and by the Finance Bureaus in each prefecture where the business is to be conducted, and the interpretation of these rules may vary.

An investor must be cautious about renegotiating the terms of distressed loans which it purchases. If the renegotiation amounts to an extension of credit (for example if the term of the loan is extended, or fresh funds are provided), the activity may constitute money lending.

THE TRANSACTIONS

Assignments

In an assignment, the seller transfers legal ownership of the loan to the buyer. Under Article 466, of the Japanese Civil Code, a debt can be assigned by agreement between the seller and the buyer provided that the terms of the debt do not prevent assignment. Japanese standard bank documentation is silent on the issue of assignment and, accordingly, assignment is permitted under Article 466.

To perfect the sale of the debt against the debtor, Article 467 of the Civil Code requires that either:

(a) the seller gives the debtor notice of the assignment; or

(b) the debtor acknowledges the assignment.

The notice or the acknowledgment must be in writing and must be date stamped (*kakutei hizuke*) by a Japanese notary public.

Under Article 468 of the Civil Code, defences including counterclaims and rights of set-off which the debtor may have had against the seller will be preserved and may be exercised against the buyer unless the debtor provides an acknowledgment of the assignment which is unconditional. Ideally, buyers would like to obtain the unconditional acknowledgment of the debtor with respect to each assigned debt. As a practical matter, with the large volumes of loans currently being assigned, and the absence of any economic reason for the debtor to give up its defences against the seller, it is not feasible to obtain unconditional acknowledgments from all debtors. Instead, notice of the assignment is given by the seller and the seller represents and warrants to the buyer that the debtor has no defences or rights or counterclaim or set-off against the seller.

For debts secured by real estate mortgages, the transfer of the mortgage from the seller to the buyer is also necessary. For a simple mortgage (being a mortgage securing a single debt), the transfer process is straight forward. The benefit of a simple mortgage is deemed to be transferred from the seller to the buyer on the assignment of the underlying debt. Separate notice to the debtor of the transfer of the mortgage is not necessary. The transfer of the mortgage need only be registered at the Legal Affairs Bureau where the mortgage is registered. This procedure can be completed by the seller and the buyer without the involvement of the debtor. The registration fee for the transfer of a mortgage is 0.2% of the amount secured.

The position is more complex with respect to an all-moneys mortgage. Prior to crystallisation, an all-moneys mortgage may secure multiple debts. Accordingly, the assignment of one secured debt does not necessarily result in the transfer of the benefit of the mortgage. This concept is recognised in Article 398-12-1 of the Civil Code which states that the consent of the mortgagor is necessary for the assignment of an all-moneys mortgage. If the mortgagor refuses to consent, the seller must apply for a public auction of the property which has the effect of crystallising the all-moneys mortgage with respect to a particular debt or series of debts. The mortgage can then be transferred in the same manner as a simple mortgage.

Special notification to the court is also necessary if the debtor is bankrupt or subject to corporate reorganisation proceedings.

Participations

In a loan participation, the buyer purchases a "participation benefit" in a portfolio of loans of the selling bank. There is no transfer of the legal interest in the loans and, accordingly, no need to notify the borrower of the transaction or to transfer the related mortgages.

A working group of the Japanese Banker's Association has issued a draft standard loan participation agreement. This document was originally designed for use with performing loans, but has been adapted by a number of sellers for use with distressed asset transactions. The draft standard agreement defines the bank that creates the participation as "the seller" and, in clause 2.1, states that "the Seller assigns the Participation Benefit to the Participant". This choice of words is unfortunate because, legally, there is no "sale" or "assignment" of any interest under the participation agreement.[8] Instead, the bank simply agrees to make payments to the participant based on payments that the bank receives in connection with a specified portfolio of loans. The participant agrees to make a payment to the bank in consideration of the grant of the rights and agrees to limit its recourse against the bank to moneys received by the bank in relation to the loan portfolio.

The main disadvantage of a participation over an assignment is that under a participation, the buyer takes the credit risk of the bank as well as the credit risk of the underlying debtors. The credit ratings of Japanese banks have deteriorated recently and this issue is of concern to many purchasers. There are several possible solutions to this problem:

(a) the bank could grant the participant a security interest over the underlying pool of loans. However, in order to perfect such a security interest it would be necessary to give notice to the debtors and to register sub-mortgages over the real estate mortgages in the portfolio; or

(b) the bank could agree to assign the portfolio of loans to the participant (or its nominee) if the credit rating of the bank is downgraded below a negotiated level.

The principal advantages of the participation structure are its simplicity and the fact that the bank does not need to reveal the existence of the transaction to its borrowers. The creation of a security interest would eliminate these advantages and, accordingly, most participation agreements adopt the credit downgrade approach.

The Transaction Process

The transaction process has become relatively standardised, for both participations and assignments. The main phases are as follows:

(a) *The Bidding Process:* The bank short lists a small number of potential bidders based on informal discussions with the bidders. The bank then provides each of the bidders with a draft of the agreement and a short description of the loans, including the status of any liens and any insolvency proceedings. Each bidder will then submit a bid which contains the bidder's offer for each loan in the portfolio and sets out any material comments on the agreement. The bank awards the transaction based on the bids.

(b) *Due Diligence:* Once a single potential buyer has been selected, the bank will provide documents to the buyer to enable the buyer to conduct due diligence. Naturally, all of the documentation is in Japanese, and Japanese lawyers play a crucial part in the due

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[8] The use of the assignment language in the participation agreement probably stems from the Japanese tax analysis of the participation agreement. The tax authorities have concluded that a participation should be characterised as a transfer of the economic benefit of the loans from the bank to the participant, and that accordingly, the bank should be entitled to write off loans that are subject to a participation. It seems that the original draftsman had these economic concepts in mind when he or she prepared the draft standard participation agreement.

diligence process. The scope of the due diligence will depend on the nature of the transaction and the scope of the representations that the seller is prepared to give. Generally, sellers have been prepared to give broader representations in relation to participation transactions, and the resulting due diligence is thus reduced. In an assignment transaction, the key areas for the due diligence review are:

(i) loan files – generally, this process is not as time consuming as might be expected because of the standardisation of Japanese documents. Usually, the most important issue is to see if there is any correspondence between the bank and the debtor which has the effect of waiving or otherwise altering any of the standard terms or prohibiting assignment;

(ii) mortgage register – the principal issues are to ensure that the bank's mortgage is properly registered, to determine the status of any mortgages that have priority to the banks mortgage and to determine whether any third party (including the tax authorities) have attempted to attach the property; and

(iii) court documents – in the case of debtors subject to bankruptcy or other insolvency proceedings, the court documents will provide an indication of the number and size of competing claims in the bankruptcy, and may assist the buyer in determining the value of the loan. It is also important to ensure that the bank has properly claimed the amount of the debt owing to the bank in connection with the insolvency proceeding, and that the amount of the debt is not in dispute.

(c) *Adjustment of the Bid:* If the due diligence inquiry reveals significant discrepancies between the information on record and the information provided by the bank, the buyer will have the opportunity to adjust its bid. Usually, bids are adjusted on a loan by loan basis, and this is the reason why the buyer is required to provide a separate price for each loan in the initial bidding phase.

(d) *Documentation:* Once the due diligence is complete, the seller and the buyer will settle the documents. In theory, the selling bank seeks to limit the ability of the buyer to negotiate the documents by asking the buyer to provide comments on material issues during the initial bidding phase. As a practical matter, nearly all buyers raise additional issues prior to the closing when the seller's negotiating position has deteriorated. The contentious documentation issues are discussed further below. The documentation is usually drafted and negotiated in Japanese, although most buyers ask for simultaneous translation of the documents.

(e) *Closing:* The complexity of the closing depends mainly on the type of transaction. The closing of a participation is very simple: the only real conditions are execution of the agreement and payment by the buyer. Closing an assignment is a much more substantial process, requiring:

- the inspection and delivery of the loan files;
- the issue of notices to debtors and related parties;
- the issue of notices to the court in the case of debtors subject to insolvency proceedings;
- the registration of the transfer of the mortgages; and
- the report of the assignment to the MOF, in the case of a buyer which is not a resident of Japan.

Documentary Issues

The documentation for both sales and participations is becoming standardised. There are approximately five law firms that are active in the market and, as a consequence of the increasing number of transactions, the basic format for agreements has been settled. Notwithstanding this, there are a number of provisions in the documents that are extensively negotiated in each transaction. The most significant are as follows:

(a) *Representations:* Naturally, the buyer would like to have broad representations while the seller would like to keep the representations as narrow as possible. The tax and regulatory regime favours the seller's position: if the seller's representations are so broad that they effectively constitute a guarantee of the obligations of the underlying debtor, the seller will not be permitted to move the loans off its balance sheet. Although subject to negotiation in each transaction, sellers typically give representations as to:

(i) the power and authority of the seller to enter into the assignment or participation agreement, and the enforceability of the assignment or participation agreement against the seller;

(ii) the power and authority of the debtors to enter into the loan agreements and the enforceability of the loan agreement against the debtors;[9]

(iii) no assignment of, or security interest over, the seller's rights under the loan agreements;

(iv) no restrictions on assignment of the loans;

(v) no defences, rights of counterclaim or set-off against the seller under the loan agreements;

(vi) no loans outstanding by the debtor to the seller, other than the loans that are being sold;

(vii) no obligation on the seller to advance further funds to the debtor;

(viii) no extinction of rights under the loan agreements due to the application of any statute of limitations;

(ix) no amendment, variation or waiver of the seller's rights under the loan agreement;

(x) no litigation regarding the loan agreements, or claims that the loan agreements are not enforceable; and

(xi) information provided by the seller in relation to the bidding process and the due diligence process is true and correct and that the disclosure of such information did not breach any duty of the seller.

Additional representations are needed in a participation transaction with respect to the fact that the seller is holding the originals of all of the relevant documents evidencing the loans. Generally, the seller is prepared to give broader representations in a participation transaction than in an assignment.

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9 Sellers frequently object to this representation. However, inclusion of the representation is becoming market practice.

The buyer would typically be required to warrant only that it has the power and authority to enter into the assignment or participation agreement, and that the assignment or participation agreement is enforceable against the buyer.

(b) *Servicing:* The provisions regarding servicing are frequently the subject of extensive negotiation. Most of the buyers have experience in servicing loans (particularly mortgage loans) in the United States, and wish to bring this experience to bear in Japan. However, under both participation agreements and, for the regulatory reasons discussed above, assignment agreements, the seller must act as the servicer. Accordingly, the buyer's position is that the seller should conduct the servicing in accordance with instructions and directions from the buyer.

The seller's position is that it wishes to minimise any disruption to its own servicing activities and to the business of its customers – even if the customers are in default. For this reason, the seller is usually only prepared to follow the instructions of the buyer if the instructions do not conflict with the "internal servicing rules" of the seller or with "the ordinary servicing procedures of Japanese banks".

The scope of these limitations is not clear, particularly since it appears that most of the sellers do not have established written servicing rules. However, despite (or perhaps because of) this vagueness, both the seller and the buyer appear to be comfortable with this position.

(c) *Confidentiality:* Although most of the buyers appear to be purchasing distressed loans for their own portfolios, they recognise that they may wish to sell the loans to other investors or to securitise the loans in the future. For this reason, the buyers would like to maintain the maximum flexibility possible in disclosing information regarding the loan portfolios to third parties.

The sellers, on the other hand, are particularly concerned that information about the transactions should not be disclosed. The issue is particularly acute in relation to participation agreements where the seller does not inform the debtor about the transaction. The sellers feel that it would be commercially embarrassing if their customers were to become aware of the transaction as the result of an inquiry directly to the customer by an investor interested in acquiring an interest in the participation from the buyer. The issue is of less importance in relation to an assignment since the debtor is aware of the transaction.

There is no simple solution to the problem of disclosure. In most transactions, a procedure has been worked out whereby the buyer must obtain an undertaking of confidentiality from sub-participants before disclosing any information regarding the loan portfolio. It remains an issue as to whether this undertaking must be given to the buyer or to the seller. If the former, the seller will not be aware of the extent to which information is being disseminated. If the latter, the buyer will be obliged to disclose its "client list" to the seller.

STRUCTURING THE INVESTMENT

Overview

Structuring the buyer's investment has been one of the most complex areas of the debt restructuring process. The main issues are taxation and, because most investments have been made by groups of investors, control and management of the assets.

Taxation

A detailed review of the issues raised by the Japanese taxation of the buyer of distressed assets is beyond the scope of this paper. Corporate tax rates in Japan are relatively high, and the objective of the buyers has been to take the income arising from the realisation of distressed assets out of Japan without the imposition of Japanese corporate tax. However, depending on the

structure of the transaction, this objective may not always be feasible. As yet there is no clear indication from the Japanese tax authorities as to how they will approach these transactions.

The main issues with respect to Japanese tax are as follows:

(a) *Characterisation of the Income:* In the case of both assignments and participations, the buyer acquires the right to receive payments from a resident of Japan. When a payment is made either to the investor either directly by the debtor or indirectly through the seller, the investor will realise income. This income will probably be construed as "income from the holding of assets".[10] As such, the income will be subject to Japanese taxation, unless an applicable tax treaty applies. Japanese corporate tax is currently imposed at the rate of 34.5%. In addition, corporations with an office[11] in Japan will be subject to local Japanese taxes at the rate of approximately 17%.

(b) *Application of the Tax Treaties:* If the buyer is not a resident of Japan for tax purposes, the applicable tax treaty will modify the Japanese domestic tax treatment of the transaction. The model OECD treaty contains an "other income" provision which provides that income which is not otherwise dealt with under the treaty will only be taxed in the country of residence of the person receiving the income. Income from the holding of assets (other than a direct holding of real estate) is treated as "other income" by the Japanese tax authorities for the purposes of these treaties. Accordingly, if the investor is located in a jurisdiction with a treaty that contains an other income provision, income from holding distressed loans[12] or from participations will not be taxed in Japan. In practice, however, most of Japan's tax treaties (including its treaty with Australia) do not contain an "other income" provision. The result is that payments in relation to distressed assets to residents of countries which do not have a treaty containing the necessary "other income" will be subject to Japanese corporate tax.

(c) *Treaty Shopping:* The analysis in the foregoing paragraph raises the issue of whether it would be possible to structure the investment through a jurisdiction which does have a treaty with Japan that contains the necessary language. Unlike many other developed nations, the Japanese tax laws do not contain a prohibition on treaty shopping. However, the Japanese tax laws do contain "taxation in substance" provisions that have a similar effect. If the transactions are structured through an entity in a favourable tax jurisdiction and the entity does not have real economic substance, the Japanese tax authorities will be able to look through the entity and to impose tax accordingly.

(d) *Silent Partnerships:* A number of transactions have used a silent partnership (*tokumei kumiai*) structure as a means of reducing Japanese taxation. In a silent partnership a Japanese entity (the proprietor – *eigyosha*) purchases the loans or enters into the participation agreement. The silent partner investors make investments into the business of the proprietor, but do not acquire any direct interest in the assets themselves.

Silent partner distributions are also characterised as income from the holding of assets, and if the investors are located in a jurisdiction with a favourable treaty, the distributions will not be subject to Japanese corporate tax. However, unlike the structure described above, if there are more than 10 investors, distributions will only be subject to a withholding tax of

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10 It is arguable that the income could also be characterised as a capital gain. In order to constitute a capital gain, the investor must "dispose" of an asset. Although there is no sale or transfer of the loans or the participation, the effect of the payment is to discharge the underlying debtor's obligations, and it is therefore arguable that the investor should be regarded as having disposed of an interest. If this argument is successful, the income should be treated as a capital gain. Characterization as a capital gain produces beneficial tax results under some treaties.

11 Under domestic Japanese tax laws an "office" is functionally equivalent to a permanent establishment.

12 This assumes that all payments in relation to the distressed debt are payments of principal. Payments of interest would be subject to withholding tax.

20% rather than full Japanese corporate tax, even if the investors are located in a jurisdiction with an unfavourable treaty. If there are less than 10 investors, silent partnership distributions will be subject to Japanese corporate tax. In addition, the investor will not be deemed to have a permanent establishment in Japan merely because the investor invests in a silent partnership. Accordingly, silent partnership distributions will not be subject to Japanese local tax.

The major drawback with a silent partnership is that the partners must remain silent: they are not permitted to control or otherwise take any active role in the management of the proprietor. If the silent partners do control or manage the proprietor, the transaction may be deemed a general partnership rather than a silent partnership, and this would render the silent partners subject to full Japanese corporate and local tax. Most of the investors wish to take an active role in the servicing and resolution of the distressed assets, and this commercial objective usually means that the silent partnership structure will not be effective.

(d) *Servicing:* At present, all of the distressed assets are being serviced by the sellers who act as independent agents of the investors and are therefore not likely to be characterised as permanent establishments of the investors in Japan. If Kuragin 800 is changed and the investors start to service the distressed loans directly, there is a significant risk that these servicing activities may amount to a permanent establishment.

Control and Management

As mentioned above, most of the investments have been made by investors acting in groups. The main reason for this appears to be that the investors can diversify their risk by investing in a number of different pools of mortgages. Further, by having a different investor take the lead on each transaction, the amount of due diligence and negotiation that each investor is required to conduct is kept to a minimum.

The problem raised by having groups of investors is one of control. Unlike a simple lending transaction where the syndicate of banks is able to delegate all of the functions of managing and administering the loan to the agent bank, the management of distressed assets requires the ongoing and extensive involvement of all of the investors in developing asset resolution strategies, and in implementing those strategies. The result is that it is necessary to incorporate extensive management and control provisions in the documentation. These provisions are usually included in a shareholders agreement or similar document constituting the special purpose company that is to act as the buyer, and is generally governed by the laws of the jurisdiction where the buyer is located.

TRENDS IN THE DISTRESSED ASSET MARKET

Overview

Following an exceptional number of transactions prior to the financial year end on March 31, 1998, the market has slowed. The balance sheets of the Japanese banks were improved by the injection of approximately $22 billion of new capital by the Japanese government. This has temporarily reduced the need of the banks to liquidate their bad debts. In addition, it appears that the Japanese banks are currently in the process of preparing for their annual shareholders' meetings in June. Most market participants believe that the market will improve in the period after the shareholders' meeting up to the end of the financial half year on September 30. Factors which will accelerate the growth of the market are:

(a) further falls in Japanese asset prices – particularly the Tokyo Stock Exchange;[13] and

(b) the introduction of accounting rules that will require Japanese banks to mark their assets to market.

Securitisation – The Present

As a group, the buyers would like to improve liquidity in the distressed debt markets in Japan. The most obvious ways this will occur will be the securitisation of distressed loans.

At this stage, the Japanese securitisation markets are relatively undeveloped. There is a special law for securitisation transactions,[14] but this law only applies to specified types of debts such as credit card receivables, auto lease rentals and auto loans. The law does not extend to the securitisation of mortgages or commercial loans.

The advantage of using the securitisation law is that notice of the assignment of the loans may be made by public notice in the gazette (*kampo*) rather than individually to each debtor. The disadvantage is that the transaction must be structured in the manner provided for in the securitisation law (which is more cumbersome than traditional securitisation structures) and that the special purpose company formed to acquire the loans must obtain a license from the Ministry of International Trade and Industry.

Two other issues with the securitisation of distressed assets are the fact that the loan portfolio does not produce a steady income stream and the fact that, as yet, the rating agencies have been unwilling to attempt to rate securities backed by distressed assets. Both of these problems will be solved, over time, if the market grows to a sufficient size and payment history statistics are developed.

Securitisation – The Future

Legislation is currently before the Japanese Diet for two new laws that should have the effect of substantially increasing the scope of securitisation in Japan.

The first law will permit the creation of special purpose companies (*tokutei mokuteki gaisha*). Currently, SPCs can be established under the Commercial Code. However, the requirements for capital for ordinary companies[15] and for their internal organisation make the use of SPCs cumbersome. The new law, which is to come into effect on September 1, 1998 will make it easier to establish and administer SPCs for distressed asset transactions. The principle features of the new law are:

- the assets that the SPC may hold are restricted to receivables, real estate and other types of non-performing loans and collateral;
- the SPC will not be permitted to conduct other types of business;
- the SPC will be permitted to raise finance by the issue of common stock, preferred stock, debt securities (bonds or commercial paper) and bank loans; and

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13 Some commentators have argued that if the fall in share prices is excessive, the sales of distressed assets may slow because the banks will not have sufficient assets to absorb the resulting losses.

14 Law Relating to the Regulation of the Business of Specified Claims, 1993 (the "Tokusaiho").

15 Currently, the minimum capital requirement is approximately $120,000 for a joint stock company (*kabushiki kaisha*). Under the SPC law, the capital requirement will be reduced to around $35,000.

- the "asset liquidation plan" for the distressed assets and the method of financing for the acquisition of the assets must be approved by the Financial Supervision Agency.

The second law, which is likely to have an even more profound effect, is a special tax law that will give the SPC a tax status similar to a US real estate investment trust (REIT). Under this proposed law:

- the SPC must either issue debt securities to the public[16] or the shareholding of the SPC must be spread so that the three largest shareholder groups do not own, either directly or indirectly, 50% or more of the shares issued by the SPC;

- more than 90% of the taxable income of SPC must be paid to the shareholders as dividends; and

- the day-to-day operations of the SPC must be outsourced.

If these conditions are met, the SPC will be entitled to a full deduction for Japanese corporate tax purposes for dividends paid to its shareholders. Dividends paid to shareholders located outside Japan will be subject to Japanese withholding tax at the rate of 20% (as reduced by applicable tax treaties).

The government is also considering changes to the real estate transfer, acquisition and holding taxes for acquisitions of real estate by the new SPCs. Given the significant Japanese taxes that are imposed on real estate acquisitions, holdings and dispositions in Japan, it seems likely that the new SPCs will quickly form an important tool in real estate financing transactions in Japan.

Servicing

The government is also considering the introduction of special legislation to allow independent asset managers to conduct servicing activities in Japan. At this stage, the new servicing law is in the discussion stage, and draft legislation is yet to be announced. As mentioned above, the Lawyer's Law currently restricts non-lawyers from performing debt servicing functions on behalf of third parties. It appears, that in an effort to compromise with the Japan Federation of Bar Associations, the government is likely to include a provision in the new servicing law which requires a Japanese lawyer to be a director of servicing companies in Japan. Other issues being discussed are the question of whether a servicing company can also purchase debts, what types of debts will be covered by the law and how servicing companies will be supervised.

Other Measures

On May 18, 1998 the Japanese government and the ruling Liberal Democratic Party announced the establishment of a special task force which will consider further reforms to the Japanese tax and regulatory rules to accelerate and facilitate the sale of distressed assets by Japanese banks.

Other Assets

The first distressed commercial loan transaction was completed in March this year. It seems likely that there will be more transactions of this kind. Japanese banks are also likely to consider selling other types of assets such as structured loans, Japanese leveraged leases and project finance transactions. Foreign investors also seem to be interested in acquiring direct ownership of Japanese real estate, and the first distressed real estate deals are currently being structured.

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[16] In order to constitute a public offering under the Securities and Exchange Law, the securities must be offered to at least 50 investors.

Other Markets

It appears that the distressed asset market is developing across Asia. A number of transactions have reportedly been completed in South Korea, and the Financial Restructuring Agency in Thailand is selling the loan assets of the 56 Thai finance companies whose licenses were suspended in June and August 1997. At this stage, the prices in other markets such as Indonesia are too volatile for a market of this type to develop, but as the political and economic situation stabilises, a distressed loan market is likely to thrive in these markets as well.

Overall, the Japanese market for distressed loans is developing rapidly and is one of the few growth areas in the Japanese economy. Although it seems that a number of Asian markets are also depressed, the Japanese experience shows that economic problems of this kind can bring opportunities. The important lesson to learn from the Japanese market is that despite the legal, regulatory and cultural differences, it is possible to develop structured financial products that offer a similar level of protection to investors as one would expect to find in other international transactions of this type.

ATTACHMENT 1 – TO PAPER PRESENTED BY JEREMY PITTS

TRANSLATION OF EXTRACTS FROM MINISTRY OF FINANCE CIRCULAR KURAGIN 800

[Original Date of Circular: April 30, 1992
Marked-up to show changes implemented on June 1, 1997]

The purpose of the circular is the promotion of liquidity in the transfer of loans which, in turn, will lead to an improvement in the capital ratios of financial institutions.

I Housing loan trusts: (not translated).

II Transfer of loans made to prefectures and municipalities: (not translated).

III Transfer of general loans made by financial institutions.

1. *Subject Loans:* This circular covers general loans governed by an agreement on bank transactions.[17]
2. *Method of Assignment:* The assignor financial institution shall assign the loan in accordance with the provisions of the Civil Code. In principle, the assignor should not have any obligation to repurchase the loan or guarantee the payment of the loan.
3. *Consent of the Debtor:* The assignment may occur with or without the consent of the debtor. However, if the assignor has requested the debtor to provide its consent, the assignment should not take place without such consent.
4. *Servicing:* In principle, the assignee must delegate the administration of the loan, including the collection of principal and interest on the loan, to the assignor financial institution. The assignor must deliver to the assignee a certificate showing details of the assigned loans.
5. *Prohibition on Resale:* The assignee may not resell the loan to a third party.
6. *Assignor:* The assignor must be the creditor financial institution which owns the loan.
7. *Assignee:* The assignee must be a financial institution or a special purpose company which has been established to purchase loans etc of financial institutions (in the latter case, the assignor financial institution should administer and collect the loans). However, if both the debtor and the assignor financial institution are listed companies, required to engage in continuous disclosure under the Securities and Exchange Law, then the assignee may be an institutional investor which is familiar with the financial markets (but not an individual).
8. *Accounting:* The assigned loan shall be classified as a loan account.
9. *Exemption:* This circular is not applicable to a special corporation established jointly by financial institutions to purchase non-performing loans in order to stabilise the financial markets.
10. *Miscellaneous:* The parties must produce and preserve documents (including their internal books) relating to the assignment of the loans. Periodic reporting of loan transfers to [the MOF] is not required, but each financial institution should monitor necessary figures.

IV Special arrangements relating to subordinated loans and perpetual subordinated loans: (not translated).

V Entrustment of loans made by financial institutions: (not translated).

VI Entrustment of loans made to prefectures and municipalities : (not translated).

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[17] Note: an agreement on bank transactions (*ginko torihiki sekyusho*) is a standard form agreement used by all Japanese financial institutions for domestic commercial and personal loans. According to the Ministry of Finance, compliance with this requirement is not mandatory and the transfer of loans which are not governed by an agreement on bank transactions is also permitted.

ATTACHMENT 2 – TO PAPER PRESENTED BY JEREMY PITTS

TREATMENT OF LOAN PARTICIPATIONS ASSOCIATED WITH LOANS BY FINANCIAL INSTITUTIONS

[Translation of Ministry of Finance Circular, June 1, 1995]

We request your understanding and observance of the following stipulations with respect to the accounting, etc for the treatment of loan participations associated with loans made by Financial Institutions.

Upon entering into a Loan Participation Agreement, the originating Financial Institution (the Financial Institution) shall explain to the Participant in a readily understandable manner the existence of risk and the substance of the underlying original loan (the Loan), and give sufficient explanation of such transactions taking into account the management capability, etc of the Participant, while the Participant shall strive to understand sufficiently data concerning the original borrower (the Borrower) and perform appropriate risk management.

I. **Accounting Treatment**

(1) Where all of the following conditions are satisfied, the Financial Institution shall record in its accounting books that a portion of the Loan corresponding to a certain percentage (the Participation Percentage) of the Loan has been sold to the Participant.

Moreover, the Participant shall record in its loan account, as a loan to the Borrower, the portion of the principal amount of the Loan corresponding to the Participation Percentage.

Conditions

(1.1) Each Loan, which is the object of the Loan Participation, is separately identified in a Loan Participation Agreement. The conditions of the Loan such as the repayment date and the interest rate relating to the Participation Percentage are applied as between the Financial Institution and the Participant.

NOTE: The preceding sentence is hard to follow in both Japanese and English. The effect of the condition is that, to the extent of the Participation Percentage, the economic benefit of the underlying loan is passed, in full, to the Participant. This is significant because it implies that the Financial Institution is not permitted to "skim" any margin off the interest rate.

(1.2) Through the sale of the profits such as money, etc paid as principal and interest paid under the Loan (Participation Profits), the Financial Institution effectively relinquishes the right to receive any future economic benefits in relation to the Loan. Moreover, the Financial Institution shall not bear the risk of any loss arising for any reason whatsoever from the Loan, which is the object of Participation Profit.

(1.3) The Financial Institution shall not have the obligation, under the Loan Participation Agreement, to repurchase the Participation Profit of the Participant, and the Financial Institution shall not have an option to repurchase the Participation Profit.

(2) In addition to provisions in (1) above, accounting treatment shall be in accordance with *Accounting Treatment and Disclosures for Loan Participation* (The Japanese Institute of Certified Public Accountants).

II. Account books and other necessary documents associated with transaction records shall be produced and maintained for Loan Participation Agreements.

III. Financial Institutions having liquidity creations in connection with a Loan Participation Agreement shall report actual results quarterly to the authorities by the 15th day of the subsequent month thereof in accordance with the attached form.

ATTACHMENT 3 – TO PAPER PRESENTED BY JEREMY PITTS

TRANSLATION OF FORM FOR REPORTING ON LOAN PARTICIPATIONS

1. LOAN PARTICIPATION TRANSACTIONS
(Month Ending in ___ of ___ Quarter of ___ (Year))

2. Name of Financial Institution

3. Contract Date

4. Name of Participant

5. Principal Participation (in 100 mil yen)

6. Loan Rate and Participation Yield (%)

7. Percentage Participation (%)

8. Difference Associated with Participation (in 1.0 mil yen)

9. Participation Consideration (100 mil yen)

10. Term of Participation (year and month)

11. Liquid returns at end of previous quarter (in 100 mil yen)

12. Redemption amount in current quarter (in 100 mil yen)

13. Liquid returns at end of current quarter (in 100 mil yen)

Notes

1. Details of each transaction shall be recorded in the foregoing table and reported by the relevant Originating Financial Institution, in question.

2. Fractional units shall be rounded.

3. In the column "Difference Associated with Participation", record "+" for Premiums and "-" for Discounts above respective numbers.

4. Even where there is no new contract in the relevant quarter, if there is a liquid return at the end of the preceding quarter, record in the column "Liquid Return at End of Previous Quarter" and report thereto.